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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of	)	
	)	
National Exchange Carrier Association, Inc.	)	ASD 99-43
Proposed 2000 Modification of Average Schedule	)	
Universal Service Formulas	)	

CC: 96-45

APPLICATION FOR REVIEW

National Exchange Carrier Association, Inc.
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April 17, 2000

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SUMMARY

On October 1, 1999, NECA filed proposed modifications to the average schedule universal service fund (USF) expense adjustment formula (USF Formula), to become effective January 1, 2000. NECA's proposal sought to increase average schedule USF payments from about $13.2 million in 1999 to about $15.9 million in 2000. Under NECA's proposal, about 346 average schedule study areas would receive USF expense adjustments (*i.e.*, payments). NECA's proposal was supported by industry comments, and opposed by no one.

On March 16, 2000, the Common Carrier Bureau's Accounting Safeguards Division (Division) issued an *Order* (*March 2000 Order*) rejecting NECA's proposal. In place of NECA's formula, the Division prescribed a new formula apparently intended to increase 2000 average schedule USF payments to average schedule companies by about 4.7%, an amount representing the rate of growth in loops among average schedule companies.

The Division's *March 2000 Order* must be set aside. First, the Division used the wrong standard to evaluate NECA's formula. Section 69.606(a) of the Commission's rules requires that the formula simulate payments that would be made to similarly-situated cost companies. In accordance with this rule, NECA designed its formula to simulate expense adjustments payable to average schedule companies.

The Division incorrectly tested how well the formula models cost per loop data, not payments, as required by the rule. As shown herein, because the relationship between cost per loop data and expense adjustments is non-linear, the tests performed by the Division are meaningless and should have been given no weight.

Even if the Division's comparison of expense adjustments to cost per loop were valid, the *March 2000 Order* ignores the explicit language of section 69.606(a) of the Commission's rules, which requires that NECA simulate payments received by similarly-situated cost companies, not "cost per loop data" or other quantities. No explanation is given for this deviation from the Commission's rules.

The *March 2000 Order* also questions NECA's formula, based on comparisons between growth in cost per loop for groups of companies and growth in expense adjustments. As NECA explained in the context of the Division's proceeding on NECA's October 1, 1998 Filing, however, changes in cost per loop for small groups of companies do not necessarily relate to changes in expense adjustments. NECA also shows herein that apparent growth in cost per loop among sample companies in 1999 was reasonable.

The *March 2000 Order* must also be set aside because the Division prescribed an adjustment to the USF formula without notice to the public and without providing an opportunity for interested parties to comment, in violation of the Administrative Procedure Act.

Accordingly, the Commission must set aside the *March 2000 Order* and approve instead NECA's proposed USF Formula filed on October 1, 1999 to become effective as of January 1, 2000.

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APPLICATION FOR REVIEW

The National Exchange Carrier Association, Inc. (NECA) hereby seeks Commission review of an order issued on March 16, 2000 by the Accounting Safeguards Division (Division) of the Common Carrier Bureau (Bureau).[1] The Division's *March 2000 Order* rejected the average schedule universal service fund (USF) expense adjustment formula (USF Formula) proposed by NECA on October 1, 1999, and prescribed in its place a formula intended to limit increases in 2000 average schedule USF payments to the percentage increase in average schedule working loops.

The Division's *March 2000 Order* must be set aside because the formula prescribed by the Division fails to produce disbursements to average schedule companies that simulate payments received by representative cost companies as required by section 69.606(a) of the Commission's Rules. Additionally, the *March 2000 Order* must be set aside on procedural grounds because the Division has prescribed an adjustment to the average schedule USF formula without giving adequate notice to interested parties and

[1] National Exchange Carrier Association, Inc. Proposed 2000 Modification of Average Schedule Formulas, ASD 99-43, *Order*, DA 00-588 (rel. Mar. 16, 2000) (*March 2000 Order*).

without providing an opportunity for comment, as required by the Administrative Procedure Act.[2]

BACKGROUND

On October 1, 1999, NECA filed proposed modifications to the interstate USF and local switching support (LSS) Formulas for average schedule companies, to become effective January 1, 2000.[3] NECA's proposal sought to increase average schedule USF payments from about $13.2 million in 1999 to about $15.9 million in 2000. Under NECA's proposal, these USF amounts would be distributed among 346 average schedule study areas.

Comments supporting NECA's filing were submitted on November 3, 1999 by the Organization for the Promotion and Advancement of Small Telecommunications Companies (OPASTCO) and the National Telephone Cooperative Association (NTCA). No oppositions were filed.

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[2] The Division's *March 2000 Order* adopts an analysis that is essentially the same as that used in a similar order issued by the Division on March 17, 1999 with respect to NECA's October 1, 1998 Filing. That Order was the subject of an Application for Review filed by NECA on April 16, 1999, which, in turn, was denied by the Commission on December 20, 1999. *See* National Exchange Carrier Association, Inc., Proposed Modifications to the 1998-99 Interstate Average Schedule Formulas, ASD 98-96, *Order*, 15 FCC Rcd 1819 (2000)(*December 1999 Order*). A Petition for Review of the Commission's December 20 Order is currently pending before the Court of Appeals for the District of Columbia Circuit. *See National Exchange Carrier Association, Inc. v. FCC, et al.*, No. 00-1055 (D.C. Cir. filed Feb. 17, 2000). Grant of NECA's Petition for Review on one or more of the grounds specified therein may be dispositive of this Application for Review of the Division's *March 2000 Order*.

[3] *See* 2000 NECA Modification of Average Schedule Universal Service Formulas, National Exchange Carrier Association, Inc., October 1, 1999. NECA filed an *Errata* on October 27, 1999 (*NECA Filing*).

On December 29, 1999, two days before the revised USF and LSS Formulas were to become effective, the Division released an order approving NECA's proposed LSS formula.[4] The Division's *December 29 Order* found, however, that further review of NECA's proposed USF Formula was necessary. Pending such review, the *December 29 Order* directed NECA to retain the then-current USF expense adjustment formula, which the Division had prescribed in its *March 1999 Order.*[5]

On March 16, 2000, the Division issued its *March 2000 Order*, denying the proposed USF Formula and directing NECA to adjust average schedule USF payments by 4.7%, an amount representing the rate of growth in loops among average schedule companies.[6] No notice or opportunity to comment on the Division's proposal was given to NECA or other interested parties.

DISCUSSION

I. THE DIVISION USED THE WRONG TESTS TO EVALUATE NECA'S PROPOSED USF FORMULA.

A. The Division Incorrectly Used a "Cost Per Loop" Test to Evaluate NECA's Expense Adjustment Formula.

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[4] *See* National Exchange Carrier Association, Inc., Proposed Modifications to the 1999-2000 Interstate Average Schedule Formulas, 15 FCC Rcd 87 (2000) (*December 29 Order*).

[5] *See* National Exchange Carrier Association, Inc., Proposed Modifications to the 1998-99 Interstate Average Schedule Formulas, ASD 98-96, *Order*, 14 FCC Rcd 4049 (1999)(*March 1999 Order*).

[6] *See March 2000 Order* at ¶ 7.

The primary basis of the Division's decision to reject NECA's proposed formula is that NECA's USF formula fails to "model" cost per loop data accurately. The Division's Order asserts, for example, that NECA's formula "does not provide a reasonable correlation between estimated cost per loop data and the sample cost per loop data."[7] According to the Division, the "coefficient of determination" relating NECA's proposed formula to the sample cost per loop data is negative, indicating "a very weak relationship between the proposed formula and the sample data."[8] Based on this analysis, the Division found that NECA's formula "does not reasonably estimate costs per loop or universal service support amounts."[9]

The Division used the wrong standard. NECA's USF expense adjustment formula cannot be evaluated based on how well it models cost per loop data because it *was not designed to model cost per loop data*. Rather, it was designed to model USF expense adjustments of sample companies, a different set of data points.[10] USF expense adjustments are determined by reference to cost per loop amounts, but, as discussed below, the relationship between the two quantities is not linear. Absent such a linear relationship, it is impossible to "test" the accuracy of NECA's formula by how well it

[7] *Id.* at ¶ 5.

[8] *Id.*

[9] *Id.*

[10] Part 36 of the Commission's rules utilizes the term "expense adjustment" to describe the payment made to a telephone company for support of high loop costs.

models cost per loop data. Therefore, the Division's test (and resulting findings with respect to the accuracy of NECA's formula) are completely invalid.[11]

NECA develops its average schedule USF formula by obtaining actual accounting data from a scientific (statistical) sample of average schedule companies.[12] As prescribed by Commission rules, average schedule companies do not use the cost separations studies specified in Part 36,[13] and thus, cannot provide separated loop cost data to NECA. However, average schedule companies do maintain the accounts from which loop cost is determined. Therefore, NECA is able to use accounting data supplied by the sample average schedule companies with loop categorization factors derived from comparable cost companies to determine *actual cost per loop amounts*. These cost per loop data can then be used to determine quite precisely the actual USF expense adjustment amounts that would be payable to the sample average schedule companies if they were to perform cost studies.

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[11] The Division's *March 1999 Order* rests on the same fundamentally flawed analysis, a point which NECA explained in detail in its *April 16 AFR*, and which the Commission's *December 1999 Order* ignores. *See* Application for Review filed by the National Exchange Carrier Association, Inc., In the Matter of National Exchange Carrier Association, Inc. Modifications to the 1998-99 Interstate Average Schedule Formulas, ASD 98-96, DA 00-530 at 12 –17 (filed April 16, 1999)(*April 16 AFR*).

[12] Each year, NECA obtains accounting data from about 100 average schedule companies selected using a stratified random sample. In conducting its annual average schedule studies, NECA utilizes data from two years' worth of sample companies, effectively doubling the sample size to 200 companies. This process is explained in detail in NECA's annual average schedule filings, and has been subject to detailed review by the Commission. *See, e.g.,* National Exchange Carrier Association, Inc., 1999 Modification of Average Schedules December 31, 1998, and Revisions to the Average Schedules Proposed by NECA on October 3, 1988, *Memorandum Opinion and Order*, 4 FCC Rcd 2804 (1989).

[13] *See* 47 C.F.R. Part 36.

NECA calculates loop costs for sample average schedule companies using essentially the same procedures specified in Part 36 for cost companies. For each average schedule study area in the sample, for example, loop cost is determined by accumulating components of accounts that are assigned to loop under the Commission's rules. In the instances where accounts must be allocated between loop and non-loop portions, NECA uses allocation ratios derived from cost companies.[14]

Section 36.631 of the Commission's Rules specifies that expense adjustments be calculated by comparing individual study areas' cost per loop to the national average cost per loop (NACPL). A study area that has a cost per loop below 115% of the NACPL receives zero support, while support for those companies above the 115% threshold receive proportionally different amounts depending on where they fall within these measures (*i.e.* over 115% to 150% or over 150%). In mathematical terms, these qualification thresholds cause the expense adjustment to be a *nonlinear mathematical transformation* of cost per loop.

The Division attempted to test NECA's formula, however, by transforming expense adjustment values produced by this model linearly to compute comparable cost per loop model values. This analysis appears to assume that because USF expense adjustment amounts are determined by the relationship of individual cost per loop

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[14] NECA procedures for using representative small company cost study data to allocate average schedule company data have been exhaustively studied and validated by the Commission in the context of NECA annual average schedule filings. *See, e.g.*, MTS and WATS Market Structure: Average Schedule Companies, *Memorandum Opinion and Order*, 6 FCC Rcd 6608 (1991).

amounts to the NACPL, NECA's expense adjustment model can be tested by seeing how well it reproduces cost per loop amounts.

This "apples to oranges" comparison is fundamentally flawed. While it is true that a relationship exists between cost per loop data and USF expense adjustments (since, after all, USF expense adjustments are determined by the degree to which cost per loop exceeds the national average), as noted above, *the relationship is not linear.* As a result, the Division's findings that NECA's formula "does not provide a reasonable correlation between estimated cost per loop and the sample cost per loop data" are simply meaningless.

Even if the Division's attempted comparison between estimated cost per loop values and actual cost per loop values were valid, its test flies in the face of section 69.606(a) of the Commission's rules, which requires that NECA's average schedule settlement formulas simulate *disbursements*, not "cost per loop" data.[15] In fact, the Commission has consistently evaluated all other average schedule formulas proposed by NECA based on whether *payments* produced by the formulas approximate the payments that companies would receive if they performed cost studies.[16] Thus, the relevant standard for evaluating NECA's proposed average schedule formula is how well the formula models USF expense adjustments (*i.e.*, payments or disbursements), not how well it models cost per loop data.

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[15] 47 C.F.R. § 69.606(a).

[16] *See, e.g.,* National Exchange Carrier Association, Inc. Proposed Modifications to Interstate Average Schedules, AAD 94-34, *Memorandum Opinion and Order*, 9 FCC Rcd 3266 (1994).

In fact, as NECA explained in its Application for Review of the Division's *March 1999 Order*, a formula designed to pass the Division's "test" by modeling cost per loop data *would grossly undercompensate average schedule companies.*[17] Yet, it appears that *only* such a formula can satisfy the "cost per loop test" applied by the Division. NECA respectfully submits that the Division's analysis in this regard rests on a fundamentally incorrect assumption, one that overlooks the explicit language of the Commission's governing rule. To avoid continuation of this error, the Commission must direct the Division to evaluate NECA's proposed formula based on how well it satisfies the requirements of the rule, not some other *ad hoc* test.

B. The Division Used Faulty Comparisons Between Changes in Cost Per Loop and USF Expense Adjustments.

The Division's *March 2000 Order* also points out that, while NECA's proposed formula would result in a 20% increase in USF support for average schedule companies, the percentage growth in loop counts nationally is only 3.4% (and among average schedule companies, only 4.7%.)[18] As NECA exhaustively explained in its *April 16 AFR,* however, there is no meaningful correlation between percentage increases in loop growth for small groups of companies and their USF expense adjustment levels. For companies at or near the 115% "threshold" level, for example, very small changes in cost

[17] The reasons for this shortfall were explained in detail in NECA's April 16, 1999 Application for Review of the Division's *March 1999 Order. See April 16 AFR* at 11. Unfortunately, the Commission's *December 1999 Order* denying NECA's 1999 Application for Review does not address this issue.

[18] *See March 2000 Order* at ¶ 6.

per loop can result in disproportionately large percentage changes in USF support. In fact, as NECA explained last year, it is possible for USF payments to change significantly for small groups of companies despite *no* change in their average costs per loop.[19]

Unfortunately, these points were not addressed in the Commission's *December 1999 Order* denying NECA's *April 16 AFR*. Until this error is addressed by the Commission, the Division appears likely to continue to evaluate NECA's proposed formulas based on the assumption that USF expense adjustment amounts for small groups of companies necessarily relate to overall average changes in cost per loop. In fact, there is little basis for this assumption, particularly for companies that (like average schedule companies) have costs at or near the 115% "threshold" level specified in the Commission's Part 36 rules governing USF expense adjustments.

The Division's Order also notes that NECA's data show that average cost per loop for the sample companies increased by nearly 10% over the previous year, and questions whether this result is consistent with recent trends among cost companies.[20] The *March 2000 Order* also points out that no increase in sample company cost per loop was

[19] This effect can be illustrated by considering two companies just below the 115% "threshold" for USF payment qualification. If one company's cost increases by $1.00 per loop, while the other company's costs decrease by the same amount, their average change in cost per loop is 0%. Yet, because one has crossed the qualification threshold, their "average" USF payment amount increases 100%. Since average schedule companies are relatively low cost (i.e., have costs per loop near the 115% threshold), disproportionate changes in USF payment levels are common. *See April 16 AFR* at 14.

[20] *March 2000 Order* at ¶ 6.

reported in last year's filing,[21] and that average growth in cost per loop for companies with fewer than 10,000 lines over the past four years has ranged from .55% to 3.20%.[22]

NECA has re-reviewed the accounting data provided by sample companies and has determined that a significant portion of the cost growth reported in NECA's 1999 filing is actually attributable to the period 1997 – 1998. These data were not, however, reflected in NECA's 1998 filing.[23] In addition, NECA determined in early 1999 that it had underallocated Rents and Benefits expenses in its 1998 Filing. These prior-year underestimates account, in part, for the apparent lack of cost growth in the 1998 study and also account for approximately 6.4% of apparent growth in 1999. Other factors contributing to cost growth in the NECA 1999 Filing include cost categorization shifts and the inclusion of a larger number of small companies in the sample, as requested by the Commission.

II. THE DIVISION FAILED TO PROVIDE ADEQUATE NOTICE AND OPPORTUNITY FOR COMMENT PRIOR TO PRESCRIBING AN ADJUSTMENT TO THE AVERAGE SCHEDULE USF FORMULA.

The Division's *March 2000 Order* directs NECA to adjust the current USF formula to reflect average increases in loop growth among average schedule companies. As a result, average schedule companies, in the aggregate, will receive 4.7 percent more

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[21] *Id.*

[22] According to the *March 2000 Order,* because loop costs are highly capital intensive, an increase of 10% in one year would be exceptionally high for an individual company, and would be "unprecedented" for a large group of companies. *Id.* at n.18.

[23] At the time of NECA's October 1, 1998 Filing, 1998 data was not yet available. Since that time, however, companies have "trued-up" their information.

in USF high cost loop support in 2000 than they received in 1999.

The Division's formula adjustment was unlawfully promulgated in violation of the Administrative Procedure Act (APA) and in violation of the Division's own stated policy.[24] Although the Division did conduct a paper hearing with respect to NECA's proposed formula,[25] it gave no formal indication that it was considering prescribing an adjustment to the current formula. NECA and other interested parties therefore had no opportunity to comment on the formula adjustment.

Section 553 of the APA requires that the Commission give notice of proposed rule changes and allow interested parties to participate in the process through written submissions prior to promulgating new substantive rules.[26] These requirements serve to ensure fairness to affected parties, and to assure that an agency has all the relevant facts

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[24] In June 1998 the Division specifically and explicitly "affirmed [its] intent to provide adequate notice and opportunity for comment with respect to future average schedule formula modifications proposed by NECA or the Commission." *See* National Exchange Carrier Association, Inc. Proposed Modifications to the 1998-99 Interstate Average Schedule Formulas, AAD 98-20, *Order*, 13 FCC Rcd 17351 (1998).

[25] *See* Pleading Cycle Established for Comments on NECA's Proposed Modification of Average Schedule Universal Service Formulas, ASD 99-43 *Public Notice*, DA 99-2105 (rel. Oct. 7, 1999).

[26] 5 U.S.C. § 553 (b)(3) provides that notice must include "either the terms or substance of the proposed rule or a description of the subjects and issues involved." 5 U.S.C. § 553 (c) states that "[a]fter notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments . . . ." The Commission has consistently employed paper notice and comment proceedings prior to adoption of NECA average schedule filings. *See, e.g.*, *Public Notice*, Pleading Cycle Established for Comments on NECA's 1996 Proposed Modifications to the Interstate Average Schedule Formulas, 11 FCC Rcd 1825 (1996).

and information to reach a resolution of a particular administrative problem or to adopt rules.[27]

The APA defines a "rule" as "the whole or part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy . . . [including] the approval or prescription for the future of rates . . . prices . . . or allowances therefore or of valuations, costs, or accounting, or practices bearing on any of the foregoing."[28]

In *City of Brookings I,* the Court found that Commission orders approving or denying NECA average schedule revisions are final and subject to review.[29] The Court found that NECA's average schedule revisions "affect the division of revenues among carriers, not rates."[30] Commission actions establishing divisions of revenues among carriers are taken pursuant to section 201(a) of the Act, which, by its terms, requires that such prescriptions be taken only after opportunity for hearing.[31] Thus, there can be little question that Commission orders prescribing changes in the average schedule formulas invoke the procedural requirements of APA "rulemaking."

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[27] *See MCI Telecommunications Corp. v. F.C.C*, 57 F.3d 1136, 1141 (D.C. Cir. 1995) *citing National Ass'n of Home Health Agencies v. Schweiker*, 690 F.2d 932, 949 (D.C. Cir. 1982).

[28] 5 U.S.C.A. § 551(4). "Rulemaking" is defined as the "agency process for formulating, amending, or repealing a rule." 5 U.S.C.A. at § 551(5).

[29] *See City of Brookings Mun. Telephone Co. v. FCC*, 822 F. 2d 1153 at 1164 n. 29 (D.C. Cir.1987)(*City of Brookings I*).

[30] *Id.*

[31] 47 U.S.C.A. § 201(a).

In this case, the Division specifically directed NECA to use the Division's formula, and submit a schedule to the Division that sets forth the payments to each average schedule company.[32] There is no question that this order is of binding effect – NECA could not, for example, pay settlements to average schedule companies based on any other formula than that approved by the Division.

The *Public Notice* announcing this proceeding did not in any way suggest that the Division was considering prescribing an increase in year 2000 average schedule USF payments over 1999 payments, based on the overall rate of growth in average schedule loops, nor did the Division explain that it was considering abandoning the "disbursement" requirement specified in section 69.606(a), in favor of a faulty "cost per loop" test.[33] No commenter suggested that the Commission take either of these actions.

Consequently, NECA and the average schedule companies affected by the Division's Order had no opportunity to comment on the Division's prescription prior to its promulgation. Had such an opportunity been provided, commenters undoubtedly would have pointed out to the Division that it is unfair to limit average schedule USF increases to the rate of growth in average schedule loops, when in fact no such limit applies to similarly-situated cost companies.

[32] *See March 2000 Order* at ¶ 7.

[33] Nor can the Division's prescription of a 4.7% increase in USF payments be considered a "logical outgrowth" of the proceeding, since as explained above, section 69.606(a) requires that the average schedule formulas simulate the disbursements that would be received by representative cost companies. The Division makes no attempt to show, for example, how or whether the prescribed formula will produce disbursements that "simulate" those paid to similarly-situated cost companies. A formula prescription that violates the Commission's own rules can hardly be seen as "logical" in any event.

Another consideration likely to have been raised by commenting parties is the fact that limiting average schedule company USF growth to the rate of growth in loops imposes a "double cap" on average schedule company USF payments. This effect occurs because NECA's proposed formula already takes into account the effects of the nationwide interim cap on universal service funding imposed under section 36.631(e) of the Commission's rules.

To assure conformance with the APA and Commission rules and to preserve the integrity of Commission processes, the Commission should set aside the Division's unlawful prescription and require the Division to conform to its stated commitment to provide adequate notice and opportunity for comment prior to prescribing future average schedule formula modifications.

CONCLUSION

Review of actions taken pursuant to delegated authority is warranted where it can be shown that the action taken is in conflict with statute, regulation, case precedent, or established Commission policy; or where erroneous findings have been made as to important or material questions of fact.[34]

Review is warranted here because the Division's findings rest on fundamentally flawed analyses. NECA has repeatedly explained that its expense adjustment model cannot be evaluated based on how well it models cost per loop data. Yet the Division's *March 2000 Order* continues to assume, without basis, that such tests are relevant. NECA has also explained that percentage changes in costs per loop for groups of

[34] 47 C.F.R. § 1.115(b)(1)(i) and (iv).

companies do not necessarily relate to changes in USF expense adjustments, yet the Division continues to criticize NECA's formulas on this basis.

Because the Division's analysis rests on material errors of fact, and because compliance with the standards reflected in the Division's analysis would result in formulas that violate the Commission's rules, the Division's *March 2000 Order* must be set aside by the Commission. The *March 2000 Order* must also be set aside on procedural grounds because the Division has prescribed a new average schedule USF expense adjustment formula without giving adequate notice to interested parties and without providing an opportunity to comment.

The Commission should therefore immediately set aside the Division's *March 2000 Order,* and approve instead NECA's proposed USF expense adjustment formula effective as of January 1, 2000, the scheduled date.

Respectfully submitted,

NATIONAL EXCHANGE CARRIER
ASSOCIATION, Inc

By: /s/ Richard A. Askoff
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April 17, 2000

<u>CERTIFICATE OF SERVICE</u>

I hereby certify that a copy of the foregoing Application was served this 17th day of April 2000 by US mail and by hand delivery to the persons listed below.

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